Written Testimony
Thomas M. Brandt, Jr.
Chief Financial Officer, TeleCommunication Systems, Inc.

On Behalf Of
AeA (American Electronics Association)

Before the Committee on Small Business Committee

December 12, 2007

Chairwoman Velazquez, Ranking Member Chabot and members of the Committee, thank you for the opportunity to testify today on behalf of AeA (the American Electronics Association) on Section 404 of the Sarbanes-Oxley Act and the burdens it continues to impose on smaller companies. We appreciate this committee's efforts with regard to the effect that implementation of Section 404 is having on smaller companies and thank you for holding today's hearing.

My name is Tom Brandt. In addition to serving as the Chairman of AeA's Sarbanes-Oxley Committee, I am the Chief Financial Officer of TeleCommunication Systems, Inc., or TCS, based in Annapolis, Maryland.

AeA is the largest association of high-tech companies in the United States with about 2,500 companies, representing all segments of the industry and 1.8 million employees.

I have served as a corporate chief financial officer for more than 20 years. I spent the first nine years of my career working as a Price Waterhouse auditor, and in the mid-1990s, I returned to Price Waterhouse for three years, which gave me an updated glimpse of the profession from the inside. In addition to being a CPA, my education includes a degree in economics and management science from Duke University and an MBA from the Wharton School of the University of Pennsylvania.

My present company, TCS, was founded in 1987, and provides mission-critical wireless technology solutions to carriers, public safety, and government customers. Our patented technology enables text messaging, and premium carrier services that are based on knowing the location of wireless devices, including navigation, traffic data to cell phones, and E-911 call routing for first responder dispatch. For the Departments of Defense, State and Homeland Security, TCS sells secure satellite-based deployable communication systems, and related technical services. The company went public in 2000, and we

currently have about 500 employees and $120 million worth of stock trading on the NASDAQ.

Section 404 Continues To Disproportionately Burden Small Public Companies

My objective today is to illustrate the burden of Section 404 compliance on smaller public companies based on my direct experience, professional background, and insights from peer technology companies. Since TCS is not much larger than the cutoff between accelerated and non-accelerated filer, ours is a good case study of the disproportionate burden of Section 404 on smaller companies. When the new Section 404 rules became effective in 2004, we were just large enough to be an "accelerated filer," so we are now completing our fourth year of Section 404 compliance. As inefficient as this regulatory impact has been on companies like mine, the adverse impact of imposing this burden on non-accelerated filers is alarming.

Even with the modest changes since the law was first passed, the new compliance cost borne by investors in our companies is far greater than the benefit of any marginal accounting reassurance. We commend the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) for addressing this issue and attempting to improve implementation through the issuance of additional guidance for issuers and auditors; however, further relief for small public companies is needed.

Regulators have suggested that the PCAOB's new Auditing Standard Number 5 (AS-5) should result in sufficient relief from excessive cost. My direct experience indicates that this is not true. The imminent application of Section 404 to non-accelerated filers will be disproportionately harmful to them, their investors, and their employees. As with any cost benefit judgment, there is a point of diminishing marginal returns where benefits are less than costs. The SEC's Advisory Committee on Smaller Public Companies provided thoughtful cost benefit recommendations for stratified exemptions from costly 404 compliance processes, which AeA supports. The relief to date falls far short of those recommendations.

Extension of Inefficiencies to "Non-Accelerated Filers Unnecessary

In the absence of action by Congress or the SEC, sharp further increases in overhead costs are about to be incurred by nearly two thousand "non-accelerated filers,"[1] that is, smaller public companies that have heretofore been exempt from Section 404 compliance. For small public companies, the bar of audit oversight and compliance is already high enough and expensive enough to reasonably protect investors from the risks of bad accounting, as evidenced by

[1] According to Hoover's, there are nearly 1,900 public companies with a market capitalization of $75 million or less. Although this is not the only factor in determining non-accelerated filer status, it provides a reasonable estimate of how many companies will soon comply with Section 404 for the first time.

our seven-fold increase in recurring audit costs since we went public. All of the CEOs and CFOs will be obliged to sign the representations required by Section 302. The objective of sustaining confidence in American capital markets is not reasonably affected – the aggregate market value of all public companies with a market capitalization of less than roughly $128 million represents only one percent of the securities traded on American exchanges.[2]

Having communicated directly with small cap investors for many years, I believe it is safe to assume that they factor the risk of a small company making an accounting error into their assignment of value to our shares. They are more concerned about our prudent use of cash and profitability. The assertion by some that pension plan investors need protection is fallacious; portfolios with low risk tolerance allow minimal investment in companies the size of the non-accelerated filers.

I emphasize that my remarks are focused on the impact of this costly requirement on small public companies, which represent a very small part of the capital traded in the US public markets. Recall that the new Sarbanes-Oxley requirements were triggered by the very large and high-profile failures of Worldcom and Enron, and our government understandably took action to reassure the world that America's capital markets are safe and strong. One proposition was that audits conducted by the CPA firms were insufficiently effective to detect the frauds or misstatements in those high-profile cases. To address this, the new law prescribed new annual audit reports, not on financial statements, but on processes. For many large companies, the proportion of incremental cost impact relative to overall profitability is negligible, and a case can be made that the accounting firms needed regulatory air cover to ensure higher fees – mainly so that they can pay the insurance premiums or build war chests to survive the legal claims that arise when something goes wrong.

TeleCommunication Systems: A Small Cap Case Study

For companies like mine, however, the incremental compliance cost, relative to the amount of capital to which the public markets have given us access, is enormous.

- In 1999, the last year before we went public and we were a $46 million company, our audit fees were about $50K.

- In 2003, the last year before Section 404 went into effect and our revenue had grown to about $100 million, the fees to our Big Four CPA firm for their annual report on our accounts were $370K. This seven-fold increase in fees on a company that had only doubled in size mainly reflects the substantial extra work required to comply with public company reporting requirements, including quarterly reviews of financial reports. This cost

[2] This data was cited in the Final Report of the Advisory Committee on Smaller Public Companies (Apr. 23, 2006). See also SEC Office of Economic Analysis, Background Statistics: Market Capitalization and Revenue of Public Companies (Apr. 6, 2006).

reflects a lot of scrutiny for a small company – before layering on Section 404.

- In 2004, our audit fees more than doubled to $770K from the previous year. For 2005, when we were supposed to realize the benefits of a second-time-through cycle, our fees actually increased 13 percent to $871K. In 2005, we also hired an internal auditor at an annual cost, with benefits, of about $130K. In 2006, we put the audit out for bids, inviting two non-Big Four firms and our incumbent to submit proposals. Our Big Four firm told us that because they were now able to rely on the work of our internal auditor, they were able to submit the lowest bid of about $621K, which is still 67 percent higher than what we paid in 2003.

- For 2007, the PCAOB's AS-5 is effective for the first time. It is supposed to lower the costs for companies like mine, by allowing some reduced redundancy of documentation activity and allowing more reliance on the work of internal people. In addition, we were able to find alternatives that allow our auditors to rely on the "work of others," as permitted under the new AS-5 guidance, with the expectation that by using other less costly internal and external sources the audit fees would decrease. Because of these developments, we asked for some reduction in our 2007 audit fees. My auditor told me that my company had already taken advantage of everything that AS-5 now allows, so I should expect our fees to remain unchanged. While the number of hours to do the work may have modestly declined, the average billing rates for auditors have risen sharply.

As a former auditor, I am sympathetic that as "deep pockets," the Big Four firms are compelled to charge more to cover their insurance and possible outlays for tort claims, as well as higher salaries to attract more people to do Sarbanes-Oxley work. But that burden should not be so disproportionately applied to small companies.

Since 2003, our annual outside-auditor cost of compliance has doubled, that is, increased by more than 100 percent — but then declined by only a few percentage points. For additional perspective, the average overall pretax profitability of our business for 2005 through 2007 has been about $2 million a year. Annual outside audit fees of more than $600K represent a big bite out of our investors' hides. The cost of the extra audit work on large securities issuers is proportionally inconsequential for most large companies. Fundamentally, however, there is a point below which the scope of audit work cannot be scaled down to be proportionate to the intended risk mitigation.

I have shared this company-specific information because over the four-year period, the nature and scope of our company operations and financial statements has been sufficiently constant to make the numbers a fair example, and a harbinger of what lies ahead for non-accelerated filers. Based on discussions

with my peers, many other companies have been hit *much harder*. In addition, I have focused *solely* on the external auditor fees, ignoring the internal man-hours that are expended on writing narratives to document the processes or doing repetitive tests of key controls that are either drained away from more productive activities or funded by adding overhead staff such as internal auditors. Most small companies will be compelled to incur additional external costs to hire consultants to write the process documentation and perform the tests of the internal controls needed to support management's certification and the auditor's work.

Benefits of "Internal Control" Audit Work Are Misunderstood

Documentation of processes and testing of controls were part of audits when I started my career in 1973. Despite common misunderstandings, then and now, the scope of this work is not designed to catch the type of fraud seen at Worldcom and Enron. It is worth noting that, to date, nearly all of the financial statement errors detected as a result of Section 404 work have entailed application of tricky, technical rules relating to tax, leases, or stock option accounting, and rarely anything significant enough to change a reasonable investor's opinion as to the value of the company.

While the SEC and the PCAOB have released new guidance in 2007 that encourages non-accelerated filers and their auditors to take an approach that is scaled to a smaller company, the key point here is that there is a point below which is it impossible to make the incremental costs proportionate to the benefits. These companies will still face additional costs related to the work needed to support management's certification, as well as an increase in cost for the external auditors' work to issue a separate opinion on internal control over financial reporting. It is not unreasonable to assume that non-accelerated filers will see the same multiples in increase in compliance and audit fees as those experienced by TCS.

When I learned of today's hearing, I wanted to testify because I am convinced that this is bad public policy. Access to capital through the issuance of publicly traded stock is a vital step in the growth of innovative, entrepreneurial businesses. For the people who are bold and successful enough to grow a company that is a candidate to go public, our small cap markets represent a valuable alternative to being forced to sell their companies or to slow growth and risk losing a competitive advantage. Some argue that companies too small to absorb Sarbanes-Oxley costs should not be allowed to issue publicly traded shares. I believe that entrepreneurs like my company's founder should have fewer, not more, obstacles to grow a business and that investors are already sufficiently informed about the risks involved. When they can attract the support of public investors, they should have the freedom to pursue their visions rather than sell out.

Conclusion: The SEC, PCAOB and Congress Should Revisit the Recommendations of the Advisory Committee on Smaller Public Companies and Implement Reasonable, Stratified Exemptions

It is hard to see any public policy benefit at all from the imposition of this incremental bureaucratic overhead on non-accelerated filers. Not only should these companies be permanently exempted, but Section 404 exemption relief should be expanded. The Advisory Committee on Smaller Public Companies' recommendations should be re-visited.